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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 528.

PACIFIC NATIONAL COMPANY, *Petitioner*,

v.

GALEN H. WELCH, Former Collector of Internal Revenue for the Sixth District of California, *Respondent*.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE PETITIONER.

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BRIEF FOR THE PETITIONER.

OPINION BELOW.

The District Court filed no opinion. Its findings of fact pecial) and conclusions of law appear at R. 23-30. The inion of the Circuit Court of Appeals (R. 198) is reported 91 F. (2d) 590.

JURISDICTION.

The judgment of the Circuit Court of Appeals was en- red August 2, 1937 (R. 207). The petition for a writ of rtiorari was filed October 5, 1937, and was granted De- mber 6, 1937. The jurisdiction of this Court is conferred Section 240(a) of the Judicial Code, as amended by the ct of February 13, 1925.

QUESTIONS PRESENTED.

1. When a taxpayer, through ignorance of a right to use any other basis, files its 1928 return on a basis which does not clearly reflect its net income, is it bound by the method so used?

2. Was petitioner or Trust No. P. T. 46 the proper entity to report the operations of the subdivision venture?

STATUTES AND TREASURY REGULATIONS INVOLVED.

The statutes and Treasury regulations involved will be found in the Appendix, *infra*, pp. 34-41.

STATEMENT.

The case was tried, without a jury (R. 22), before the District Court of the United States for the Southern District of California, Central Division. Special findings of fact were requested (R. 159-178) and errors were assigned on appeal below regarding the failure of the District Court to find numerous material facts (R. 183-188). The Circuit Court of Appeals summarized much of the evidence in its opinion (R. 199-205), but decided against petitioner on a proposition of law. The principal facts, shown from the Bill of Exceptions (R. 37-181), are as follows:

Petitioner, which was primarily a holding company for stocks of certain banks (R. 110), purchased in 1927 a tract of land in Culver City, Los Angeles County, California, for $609,000.00, of which $309,000.00 was paid in cash. Five notes, aggregating $300,000.00, were given by petitioner to the seller to cover the remainder of the purchase price and the properties were conveyed to the Pacific National Bank, as Trustee of Trust No. P. T. 46 (R. 44, 68-93).

Under this indenture the Trustee was to execute all contracts of sales for the lots (R. 82), to receive initial and installment payments and to apply the sums so received to (1) expenses of the trust; (2) expenses of subdividing, improv-

ing and selling the lots; (3) a fund to amortize the notes; and (4) the balance, if any, to petitioner (R. 83-84). After the notes had been amortized, the trust was to continue for petitioner's benefit (R. 84), but for a period not exceeding twenty years (R. 90).

Pursuant to the trust indenture, the Trustee caused the property to be platted and subdivided and arranged for the sales of subdivision lots by one Elwell, an experienced real estate agent (R. 115, 141-142). It developed that an error had been made as to the area acquired, and Elwell tried with but little success to sell the lots at high enough prices to return the sum originally intended to be secured from the venture (R. 116-117). One Brick solicited the Trustee for an opportunity to sell the lots and was employed by petitioner (R. 117, 44) as exclusive selling agent. Under the selling contract (R. 54-67) Brick was to secure minimum prices (R. 61-67) which greatly exceeded those regarded by Elwell as reasonable (R. 116, 117), and was to receive commissions of 35 per cent and more for his services (R. 57-60).

The lots were to be sold for initial payments of not less than 25 per cent of the total selling prices, the balances of such prices being payable in monthly, quarterly or semi-annual installments over periods not exceeding five years from the dates of sales (R. 55-56).

Brick used the "lunch and lecture" method of selling lots (R. 117), and by December 31, 1928, had sold 257 lots for prices amounting in the aggregate to $838,026.25 (R. 144). Of these, 13 were cash sales for an aggregate price of $41,144.25 (R. 143). The installment sales were made for initial payments of about 25 per cent of the selling prices (R. 108). By December 31, 1928, 16 accounts, amounting to $35,274.51, had been cancelled and 92 accounts, or 40 per cent of the total number of accounts, were delinquent. These delinquent accounts amounted to $201,674.56, which was 38 per cent of the total of the unpaid accounts (R. 143).

Petitioner's 1928 income tax return was prepared by its secretary, who was an inexperienced young man (R. 107),

who got the data concerning sales of subdivision lots from the Trustee of Trust No. P. T. 46 (R. 112). On the tax return the transactions for both 1927 and 1928 were included and the taxable income was arrived at as if petitioner had sold the lots (R. 108, 111).

The secretary was ignorant of all of the permissible methods of determining income from sales on the deferred payment plan (R. 108), and apparently believed that the entries made upon books kept by him wholly governed the amounts of income to be reported in the tax return (R. 111).

Upon petitioner's books and in the return the sales were treated as completed sales and the purchaser obligations were treated as being the equivalent of cash (R. 43, 108, 111, 119). By this treatment of the sales of subdivision lots, income from that venture in the sum of $137,007.17 was shown as received by petitioner (R. 42-43). Petitioner in fact received no cash distributions from the trust in 1928, and paid some $50,000.00 into the trust to reduce the debt to the original seller of the land (R. 112). Such benefits as petitioner derived from the operations were the amounts out of the various installments which were applied by the Trustee on the purchase money notes. In December, 1931, petitioner disposed of its beneficial interest in Trust No. P. T. 46, in partial settlement of a guaranty obligation to the Transamerica Corporation, and at that time over $100,000.00 was still owed on the purchase money notes (R. 123, 124).

Petitioner by a timely claim for refund (R. 41) sought a redetermination of income from the real estate venture upon the installment basis (R. 47, 48), and by an amended claim for refund (R. 41) filed after the period of limitations, but while the first claim was under consideration, asserted the additional ground that Trust No. P. T. 46, and not petitioner, should have made the return of income from the real estate venture (R. 51-52). The refund claims were rejected, except as to items not here involved (R. 27, 28, 42), and suit for a refund was instituted in the District Court.

On January 3, 1935 (which was after the initiation of the

suit), the then Trustee of Trust No. P. T. 46 filed delinquent fiduciary returns for the trust (R. 43, 121-122). These returns treated the deferred payment sales of lots as sales on the installment plan (R. 148, 153). Upon application of the installment basis, the aggregate income from the venture for the years 1927 and 1928 amounted to $44,048.10, and the income distributable to petitioner, after various deductions, was $19,894.89 for the combined periods (R. 146, 151).

It was stipulated in the trial court that there would be some amount of refund due if petitioner is entitled to have the sales of lots treated as installment sales, and that no income would escape taxation in subsequent years by reason of the statute of limitations if the income for 1928 is determined upon the installment basis (R. 118).

It was stipulated in the trial court that if petitioner prevails in its contention that it is entitled to a redetermination of its tax, the matter may be referred back to the parties for agreement and that if the parties are unable to agree, each shall submit his computation to court and shall have the right to introduce further evidence as to necessary figures (R. 44-45).

SPECIFICATIONS OF ERROR TO BE URGED.

The Circuit Court of Appeals erred in holding that the use of a method of reporting income which did not correctly reflect income, through ignorance of the statutory methods authorized to be used, constituted a binding election, estopping petitioner from using a statutory method which does correctly reflect net income.

The Circuit Court of Appeals erred in failing to decide that, although Trust No. P. T. 46 was not in 1928 an association taxable as a corporation, it nevertheless was the taxable entity required by law to report the income from the real estate venture, and that petitioner's income was overstated to the extent that it exceeded petitioner's distributable share of the net incomes from the trust, determined on the installment basis.

SUMMARY OF ARGUMENT.

Petitioner seeks correction of an erroneous overstatement of income which petitioner made, in its 1928 income tax return, as representing the amount of gain or profit realized by it in 1928 from the installment-plan sales of subdivision lots by Trust No. P. T. 46, of which petitioner was beneficiary. To reflect clearly the income from these contracts, the income should be calculated on the installment basis specifically provided for in the law. The terms and the circumstances surrounding the sales make this plain. When the income is so calculated it is stipulated that some refund results.

The error made by taxpayer was not a mere error in choosing between two permissible courses of reporting income; the overstatement of tax was due to the use of figures which did not reflect income and were not in accordance with any prescribed or permissible method of calculating income. The normal method, in the case of installment-plan sales, was the installment basis now contended for; the only other permissible basis was a method in which the fair market value of the installment obligations would be determined and the sale treated as closed at that value in the taxable year. Petitioner followed neither of these methods. Being ignorant of both, it treated the sales as if they had been sales for cash at the figures mentioned in the contracts.

Petitioner's error was an honest mistake; taxpayers who make such mistakes are permitted under the income tax law to have them corrected if they do not permit their rights to be barred by a statute of limitations. No such bar is here involved.

Both of the lower courts misconceived the tax law as providing that in the circumstances of this case petitioner made a binding election, preventing later correction of its error. In so doing, they confused the situation existing in this case with the instances in which taxpayers chose and actually applied one or the other of the permissible methods mentioned above, under such circumstances that either method

would clearly reflect the income. Neither the law nor the regulations support the conclusion that the error made by petitioner must stand uncorrected, and as a matter of law no administrative discretion exists in the Commissioner of Internal Revenue, on such facts as here appear, warranting the decisions below. Nor is any element of estoppel involved.

If petitioner was further wrong in making its return as if the trust were merely petitioner's agent (rather than as if the petitioner was a beneficiary of a business trust such that beneficiaries report only income distributable to them), it nevertheless remains true that the income from these sales should be calculated on the installment basis provided in Section 44 of the Revenue Act of 1928.

ARGUMENT.

I.

The Installment Basis Alone Reflects Income from the Real Estate Venture.

This portion of the argument refers to the petitioner herein as if it were actually the seller of the lots in question—following the theory that when the sales were made by the Pacific National Bank, Trustee of Trust No. P. T. 46, the trust was to be treated as a direct agent for petitioner. An argument that the real taxable entity here was the trust, not the petitioner, and that for tax purposes this petitioner is to be treated merely as a beneficiary of a trust, is presented herein beginning at page 26. Whichever of these theories is accepted, the installment basis (actually used by the trustee in making delinquent returns for the trust (R. 121, 148, 151)) is the proper basis, as argued in this brief.

A. The installment basis was the right method under the facts and the law.

The real estate subdivision venture was initiated in the fall of 1927 and its operations for that year and for the entire year 1928 were reflected for the first time in the tax return of petitioner for the taxable year 1928 (R. 108). Approximately 95 per cent of the lots sold by petitioner to December 31, 1928 were on the installment plan (R. 143), and in most instances the initial payments were 25 per cent of the selling prices (R. 108), which was the minimum down payment specified in the contract with the selling agent (R. 55).

The Revenue Act of 1928 (Appendix, pp. 34-35) contains an express provision as to how sales on the installment plan of precisely this type may be treated. In Section 44 it is provided that in the case of a sale of real property, if the initial payments do not exceed forty per cent of the selling price, "the income may, under regulations prescribed by the Commissioner with the approval of the Secretary", be returned on the so-called "installment basis", under which a person who sells property

> "may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price."

The regulations prescribed by the Commissioner with the approval of the Secretary, under the authority of this section, are found in Articles 352 to 354, of Treasury Regulations 74 (Appendix, pp. 36-38). They impose no limitations on the privilege granted in that section. Under these regulations, just as under the provisions of Section 44, this taxpayer was granted the privilege of having its income from the real estate venture determined on the installment basis above outlined, and this is the privilege which the taxpayer now seeks. The Commissioner has declined to grant the taxpayer this privilege.

The respondent's defense of the Commissioner's conduct in refusing to permit this taxpayer the privilege thus granted in the law is that the taxpayer in making its return has precluded itself from using the installment basis, by the way income was reported on the return. We submit that this position is not based on anything contained in the Commissioner's regulations, which contain no suggestion that a taxpayer who makes an erroneous return is thereafter prevented from having the error corrected. Nor do the regulations provide that a taxpayer desiring to take advantage of the privilege granted him in Section 44 can exercise that privilege only at the time of filing his original return. The regulations (Art. 322) do provide that a taxpayer who has once adopted an installment basis or a noninstallment basis must adhere to the method he chose until the Commissioner grants him the privilege of changing it, but that provision of the regulations, relating to changes from one permissible basis to another permissible basis, has no relation to a case like this in which, prior to the year 1928, the taxpayer had had no occasion to make a choice, and in which (as shown *post*, pp. 10-13) the taxpayer's original 1928 return was simply erroneous and the tax not calculated on any permissible basis.

The Commissioner's refusal to permit the use by petitioner of the installment basis was contrary to interpretations of the statute and the regulations, as applied to similar situations, by the courts and by the Board of Tax Appeals. Compare *Morrow, Becker & Ewing, Inc.* v. *Commissioner*, 57 F. (2d) 1 (C. C. A. 5th); *Kaplan* v. *United States*, 18 F. Supp. 965, 967 (Ct. Cls.); *Key Largo Shores Properties, Inc.* v. *Commissioner*, 21 B. T. A. 1008, 1012; *Ives Dairy, Inc.* v. *Commissioner*, 23 B. T. A. 579, 584, affirmed 65 F. (2d) 135 (C. C. A. 5th), hereinafter discussed (*post*, pp. 17-20).

The United States Court of Claims in the case of *Kaplan* v. *United States*, 18 F. Supp. 965, 967, involving a casual sale of personal property, but otherwise analogous to the

facts of this case, permitted a refund to be recovered upon application of the installment sales method of accounting, and held that no binding *choice* resulted from the fact that the petitioner had filed his tax return on the basis of a completed sale. The Court disposed of a contention that the words "may return" used in Section 44(a) of the Revenue Act of 1928 imported a "binding election" as follows (at page 968):

> "* * * It is clear that the words 'may return' were used to permit the large number of taxpayers engaged in the installment-sales business to use either the accrual method or the installment-sales method of reporting income, and even where the former is used the statute permits a change to the installment method. The regulations do not so much as imply that a choice of computing profit on one or the other method in reporting a casual sale of property shall be construed as a binding election. The statute gives the Commissioner no discretionary power to reject a timely claim for refund or to refuse to compute a taxpayer's income in a case like the one at bar where the taxpayer on the cash receipts and disbursements basis receives in the taxable year less than 40 per cent. of the sales price under an installment-sales contract. * * *"

B. Petitioner's return was wrong in fact and not in accordance with the law or regulations.

The officer who prepared petitioner's 1928 income tax return was inexperienced in such matters (R. 107) and had a number of erroneous conceptions of what the law and regulations required in that connection. One erroneous view was that, because the books, also kept by him, had carried the purchaser obligations at face values and were otherwise on a strict receipts and disbursements basis, it was necessary for him to treat the sales as completed or cash sales and the purchaser obligations as the equivalent of cash at par in preparing the tax return (R. 108, 111). Neither the law nor the regulations authorized what he did.

Under general principles governing the determination of income from an exchange of property for cash and obligations of a purchaser, it is necessary to compare the "basis" for the property with the sum of "any money received plus the fair market value of the property (other than money) received" (Sec. 111(a) and (c), Rev. Act 1928).[1] In petitioner's sales of subdivision lots the "properties" to be valued were the purchaser obligations (Regs. 74, Arts. 353-354).[2]

Determinations of the fair market values of purchaser obligations are required in the case of installment sales of real estate whether the obligations are represented by promissory notes or, as here, merely by contracts to make future payments. Compare G. C. M. 3350, VII-1 C. B. p. 62; O. D. 842, 4 C. B. p. 89.

In cases where it appears that the purchaser obligations have no fair market values, the sales are not treated as "closed". Instead, the installment payments are used to reduce the "basis" for the properties sold and no income is to be accounted for until the capital investment has been recovered. Compare *Georgia-Florida Land Company* v. *Commissioner*, 16 B. T. A. 1253, 1259; *Ives Dairy, Inc.* v. *Commissioner*, 23 B. T. A. 579, affirmed 65 F. (2d) 135 (C. C.

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[1] Sec. 111(c), Rev. Act 1928, provides:

> "*Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

[2] Art. 353 (Appendix, pp. 37-38) provides that if a taxpayer uses the receipts and disbursements basis, or the straight accrual basis, instead of the installment basis, then income from installment sales shall be determined as in the case of "deferred-payment sales not on the installment plan." Art. 354 prescribes the procedure in such cases as follows:

> "In transactions included in class (2) in article 352, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash *to the amount of their fair market value* in ascertaining the profit or loss from the transaction." (Italics supplied)

A. 5th); *Biscayne Bay Islands Company* v. *Commissioner*, 23 B. T. A. 731, 735-736; *Burnet* v. *Logan*, 283 U. S. 404.

It is thus plain that sales of real estate on the deferred payment plan may be treated as "closed" or completed sales only (a) where the installment obligations have fair market values at the times when the contracts are received by the vendor; and (b) where those fair market values have been determined by the taxpayer and used in determining income from each sale.

The officer who prepared petitioner's return did not know that the installment basis was available, nor did he know that if the installment basis was not used the regulations required that the sales contracts be set up at their fair market values (R. 108). The officer got his impressions as to what was required from some book of regulations (R. 108). Since Treasury Regulations 74, containing the information (Art. 352) that sales with initial payments not exceeding 40 per cent of selling prices could be treated as installment sales, were not approved by the Secretary of the Treasury until February 15, 1929 (Regs. 74, p. 344), which was only thirty days before petitioner's tax return was filed (R. 41), it is reasonable to suppose that those regulations were not at hand. In *Morrow, Becker & Ewing, Inc.* v. *Commissioner*, 57 F. (2d) 1 (C. C. A. 5th), lack of access to Treasury regulations was held material in determining whether a change to the installment basis was permissible after a return employing another basis had been filed.

In any event, it is plain that petitioner's return was not in accordance with *any* procedure authorized by the regulations and was simply an erroneous return.[3]

Even in cases where *elections* are required as between two different kinds of tax returns, it seems generally recognized that the choice must have been voluntary and definite and

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[3] Error on the part of the District Court in concluding (R. 29) that the return was in accordance with the law and regulations was duly assigned (R. 184) and that question was thus before the court below.

the method of return selected a valid and proper one. *Commissioner* v. *Union Pacific Railroad Co.*, 86 F. (2d) 637, 639 (C. C. A. 2nd); *Lucas* v. *Sterling Oil & Gas Co.*, 62 F. (2d) 951, 952 (C. C. A. 6th); *Pictorial Review Co.* v. *Helvering*, 68 F. (2d) 766, 768-769 (App. D. C.), distinguishing *Radiant Glass Company* v. *Burnet*, 54 F. (2d) 718, 719 (App. D. C.); *Patent Royalties Corp.* v. *Commissioner*, 65 F. (2d) 580, 581 (C. C. A. 2nd); *McIntosh* v. *Wilkinson*, 36 F. (2d) 807, 808 (D. C. Wis.); *Queen City Woodworks & Lumber Co.* v. *Crooks*, 7 F. Supp. 684, 685 (D. C. Mo.).

C. The installment basis will most clearly reflect income from the sales involved.

The installment sales in this case were at high prices (R. 61-67, 117), and the lots were sold by "lunch and lecture" methods (R. 110, 117) by an agent whose commissions, according to the contract of employment (R. 55), began at 35 per cent of the selling prices (R. 57-59).

Two hundred and fifty-seven lots had been sold by December 31, 1928, the first full year of the venture, and the total of the contract prices was $838,026.25 (R. 144). Of these, 13 were cash sales for an aggregate consideration of $41,144.25. At December 31st, 16 accounts, amounting to $35,274.51, had been cancelled and there remained on the books 228 accounts, having an aggregate unpaid balance of $525,436.94. Of these accounts, 40 per cent in number and 38 per cent in amount, totaling $201,674.56, were delinquent (R. 143).

When it is considered, in addition to the foregoing, that most of the sales were at initial payments of only about 25 per cent of the selling prices and that the delinquencies occurred before the end of the first year of the venture,[4] it becomes apparent that petitioner's return was wholly erroneous *on the basis of the facts*, in treating the sales as cash

[4] Only 14 sales occurred in 1927 (R. 144), and were included in the 1928 tax return (R. 108).

sales or completed sales in which the unpaid obligations of purchasers were the equivalent of cash (R. 108)..

Petitioner acquired the land which was subdivided for a total consideration of $609,000.00, of which $309,000.00 was paid in cash and the balance of $300,000.00 was represented by five of petitioner's notes, payable over a period ending July 15, 1931 (R. 69-72). In connection with the total sales of $838,026.25 to December 31, 1928, selling commissions of $273,711.30 were incurred. The costs of the lots (allocated upon the basis of selling prices (R. 108)) amounted to $445,344.90, leaving a gross profit to be realized, *if all of the obligations were fully paid*, $118,954.05 (R. 144).

Since, however, 38 per cent in amount of the unpaid obligations, amounting to $201,674.56 (R. 143), were delinquent at December 31, 1928, it would be necessary to assume, in concluding that any income whatever would result from the venture, (1) that those unpaid obligations not delinquent in 1928 would be paid in full; and (2) that $82,720.51,[5] or an average of over 40 per cent of the face amounts of the delinquent accounts, would ultimately be paid before *any* profit or income from the venture would be realized by petitioner.

The facts stated above show beyond question, it is submitted, that many of the purchaser obligations would not be paid in full. This is corroborated by the fact that petitioner found it necessary to pay into the trust about $50,000.00 of new money to be applied on the purchase money debt in 1928 (R. 112), and that when petitioner disposed of its beneficial interest in the venture in December, 1931 (R. 123), there was still over $100,000.00 due on that debt (R. 124), which under the planned program of the venture, as reflected by the Trust Agreement (R. 68, 83-84),

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[5] This amount is the difference between the total possible profit and the amount of the delinquent accounts at December 31, 1928, and gives no effect to the probability that other accounts would become delinquent or wholly uncollectible.

should have been wholly paid by July 15, 1931, when the last of the purchase money notes became due (R. 72).

Under the facts of this case the only reasonable or proper method of determining income was the installment basis authorized by Section 44 of the 1928 Act, under which part of each installment, as and when actually received, would be allocated to capital and a part to gain. The amount so determined to be gain would approximate the amounts actually paid to petitioner by the trust, or applied for petitioner's benefit upon the purchase money notes.

D. The statute, regulations and precedents support petitioner's right to use the installment basis.

The Treasury Department since the Revenue Act of 1917 has recognized in its regulations[6] that income from installment sales where small initial payments were involved would be most clearly reflected by having the recognition of income keyed to, and dependent upon, the actual receipt of installment payments, and has permitted the use of the installment basis principle with only minor variations since that time. This was in order to give some alleviation from the hardships involved in the application of the cash or accrual basis of determining income. *Burnet* v. *S. & L. Building Corporation*, 288 U. S. 406, 413.

Doubt having been cast by the Board of Tax Appeals upon the validity of the Treasury regulations allowing the use of the installment basis, Congress in the Revenue Act of 1926 (c. 27, 44 Stat. 9, Sec. 212(d)) made specific provisions for the use of the installment basis. Its broad purpose is reflected by the following quotation from Senate Report No. 52, 69th Congress, 1st Session, at page 19:

> "The application of the installment basis as provided in the committee amendment should eliminate necessity for appraisals of the obligations of the purchaser in

[6] Treasury Regs. 33, Art. 117; Regs. 45, Arts. 44, 45; Regs. 62, Arts. 44, 45; Regs. 65, Arts. 44, 45.

> deferred-payment sales, as required under the Board of Tax Appeals decisions, save in those cases where, because of a large initial payment, i. e., one in excess of 25 per cent of the price, the property sold and serving as security for the unpaid balance has a value adequate to give the obligations a market value."

In the 1928 Act Congress, by Section 44(b), liberalized the definition of an "installment sale" so as to include sales in which initial payments did not exceed 40 per cent of the selling prices. This was explained in Senate Report No. 960, 70th Congress, 1st Session, at page 22, where it was said:

> "* * * It was believed that the 25 per cent limitation in the 1926 act forced the reporting on the accrual basis of sales in which the initial payment, though larger than 25 per cent, was insufficient to create *a substantial assurance of the actual payment of the full amount of the deferred purchase price.*" (Italics supplied)

It seems significant in this connection that Regulations 74, Article 353, treats the installment basis as the one ordinarily to be used, and the use of another basis is merely said to be "permissible" under special conditions.[7]

The decision of the Circuit Court of Appeals, which reviewed most of the foregoing evidence in its opinion (R. 199-205), that petitioner was bound by its original tax return, necessarily ascribed to the Commissioner powers which he did not have under the law applicable to this case.

It may be assumed that there sometimes exists, even in the absence of statutory provisions or notice by regulations, power on the part of the Commissioner of Internal Reve-

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[7] Art. 353 provides in this connection as follows:

> "If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan."

nue to refuse to permit a maker of installment sales to adopt the installment basis after having filed a return in which the income from such sales was determined upon another proper basis. However, petitioner submits, upon principle, and upon authority of the cases hereafter discussed, that the existence of such discretion depends *as a matter of law* upon the existence of circumstances not found in this case. These are:

1. The original determination of income in the tax return must have been in accordance with specific provisions of the law and the regulations.

2. The basis employed in the return must be one which clearly reflects income in the particular situation dealt with.

Petitioner's case is quite similar on the facts to the case of *Morrow, Becker & Ewing, Inc.* v. *Commissioner,* 57 F. (2d) 1, 2 (C. C. A. 5th). In that case, as here, a single subdivision venture was involved and most of the lots were sold on an installment plan. In the majority of sales the initial payment did not exceed one-fourth of the sales price. The subdivision was in Florida, and by the end of the first year (1925), land prices in the vicinity had dropped considerably and defaults had occurred in respect of 62 out of a total of 305 contracts. The taxpayer filed its return for the year 1925, shortly after the enactment of the Revenue Act of 1926 permitting the use of the installment basis, but before Treasury regulations were available. That return included all sales, whether cash or installment, as one item and made deductions based upon the venture as a whole. Upon learning of the installment sales provisions in the Revenue Act of 1926, the taxpayer filed an amended return which the Commissioner refused to recognize. Of this refusal the Circuit Court of Appeals said (at page 2):

> "While there is no statutory authority for an amended return, amended returns are frequently per-

mitted, and they are sometimes required by the Commissioner. In fact, the Commissioner has authority to make them when a taxpayer neglects or declines to do so. The case presented is not one where, the law being well settled, the taxpayer had elected to keep his books on a certain basis and to make returns accordingly and had afterwards attempted to change the method of accounting or the basis of the return. In that case it would, of course, be proper to hold him estopped, as an orderly administration of the revenue laws would be otherwise impossible. In this case the Commissioner put his refusal to allow the amended return on the ground that petitioner had chosen the installment basis for reporting profits and could not change. This gave no effect to changes in the law and regulations occurring afterwards. In view of the radical changes in the law, of which the petitioner had scant notice, if any, in fairness and justice to the taxpayer the returns should have been received and considered. Taxes are assessed on income and not on honest mistakes of the taxpayer. It was the duty of the Commissioner to do nothing arbitrary or unreasonable that would deprive petitioner of rights created by the new law and the regulations thereunder. It was a breach of discretion on the part of the Commissioner not to receive the amended return from 1925 under the circumstances disclosed."

Similar changes of basis have been permitted by the Board of Tax Appeals in *Key Largo Shores Properties, Inc.* v. *Commissioner*, 21 B. T. A. 1008, 1012, and *Ives Dairy, Inc.* v. *Commissioner*, 23 B. T. A. 579, 584, affirmed 65 F. (2d) 135 (C. C. A. 5th), cases where taxpayers, having filed returns reflecting sales of real estate subdivision properties by use of the installment method, were permitted to change to the deferred payment method because it appeared that the obligations of the purchasers were in fact worthless and that the method originally used did not reflect the income. In the case of *Key Largo Shores Properties, Inc.*, the Board distinguished certain of its earlier decisions where changes to or from the installment method were held not permissible as follows (at page 1011):

"The cited cases either presume or decide that the method first employed by the taxpayer served to reflect the true income and proceed on the theory that in such cases it is in the interest of administrative expediency to require adherence to the method first elected."[8]

The Board stated the basis for its decision that Key Largo Shores Properties, Inc., was not bound by its original return as follows (at page 1012):

"Under the Revenue Acts various methods of reporting income may be adopted by taxpayers, but all are designed to correctly reflect the true income in order that a just tax may be levied and collected. If a method used by a taxpayer does not clearly reflect income, the respondent may determine the income according to a method which in his opinion does clearly reflect it. Section 212, Revenue Act of 1926. This in itself is sufficient to demonstrate that it was not intended that taxpayers should be irrevocably bound by the election of a method of reporting when that method is erroneous. The effect in this case of requiring adherence to the basis originally adopted by the taxpayer would be to set up and tax, as income, an amount which in fact is not income. Neither administrative rules nor the forceful arguments in favor of administrative expediency can create income where in fact there is none, and, after all, it is only income that is to be taxed. In our opinion the installment basis when applied to the facts in the present case does not reflect the taxpayer's income."

In *Kaplan* v. *United States*, 18 F. Supp. 965, 967-968, the Court of Claims allowed a refund predicated upon a redetermination of income from installment sales of personal property (also governed by Section 44(b) of the Revenue Act of 1928) through the application of the installment sales meth-

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[8] *Strauss* v. *Commissioner*, 33 B. T. A. 855, affirmed *per curiam* 87 F. (2d) 1018 (C. C. A. 2nd); *Rundel* v. *Commissioner*, 21 B. T. A. 1019; *Johnson Realty Trust* v. *Commissioner*, 21 B. T. A. 1333; *Ellis* v. *Commissioner*, 16 B. T. A. 1225; *Viault* v. *Commissioner*; 36 B. T. A. 430, cited by respondent in the Brief in Opposition (p. 7), all involve conclusions or assumptions that the basis first used did reflect income.

od, over the objection that the use of a different method in the original tax return constituted an election of method which must stand. After holding that the law imposed no duty to make an election, the Court pointed out that the method used in the tax return would not reflect income by reason of events which had occurred after the close of the tax year, but before the Commissioner rejected the taxpayer's claim for refund.

Petitioner in the instant case in December, 1931, assigned its beneficial interest in the trust to a nominee of the Transamerica Corporation in partial settlement of a guaranty obligation to that company (R. 123-124). At that time there was still an incumbrance of $100,000.00 on the trust property (R. 124), and it may reasonably be inferred that petitioner ultimately sustained a loss from its participation in the venture.

There is not here involved any of the situations which existed in the cases cited by the Circuit Court of Appeals in its opinion (R. 206) as authority for the proposition that the Revenue Act of 1928 required petitioner, at the time of filing its 1928 tax return, to make a final and irrevocable election to use or not to use the installment basis for determining income from its real estate venture. Those cases[9]

[9] The cases cited by the court below and by respondent in his brief in opposition to the writ (pp. 6-7) involved (a) efforts by affiliated corporations, after the time limit for filing tax returns, to change either to or from separate or consolidated corporation income tax returns (*Alameda Investment Company* v. *McLaughlin*, 33 F. (2d) 120 (C. C. A. 9th); *Radiant Glass Company* v. *Burnet*, 54 F. (2d) 718, 719 (App. D. C.); *Safety Electric Products Co., Inc.* v. *Helvering*, 70 F. (2d) 439, 441 (C. C. A. 9th); *Dr. Pepper Bottling Co.* v. *Commissioner*, 69 F. (2d) 768 (C. C. A. 5th); *Lucas* v. *St. Louis National Baseball Club*, 42 F. (2d) 984 (C. C. A. 8th), certiorari denied 282 U. S. 883); or (b) efforts of married persons to make belated changes to or from separate or joint individual income tax returns (*Rose* v. *Grant*, 39 F. (2d) 340, 341 (C. C. A. 5th); *Buttolph* v. *Commissioner*, 29 F. (2d) 695, 696 (C. C. A. 7th); *United States* v. *Pettigrew*, 81 F. (2d) 666, 667 (C. C. A. 9th); *Morris* v. *Commissioner*, 40 F. (2d) 504 (C. C. A. 2nd); *Anderson* v. *United States*, 48 F. (2d) 201 (C. C. A. 5th)). Compare *McIntosh* v. *Wilkinson*, 36 F. (2d) 807 (D. C. Wis.).

(with one exception)[10] involved efforts by taxpayers to change from one authorized kind of complete tax return to another kind of return *after the special period of limitations* prescribed by law for the filing of tax returns had expired.

Petitioner's failure to determine income from the sales of subdivision lots on the installment basis in its return for 1928 (which was the initial year for determining income from such sales), is to be treated no differently than other common errors of taxpayers such as the failure in preparing a tax return to take a statutory deduction or allowance. Corrections of such errors are expressly authorized, provided (as is here the case) a proper and timely claim for refund is filed, asking that the taxable income be redetermined on the proper basis. (Sec. 322, Rev. Act 1928; and Sec. 3220, Revised Statutes, as amended by Sec. 1111, Rev. Act 1926, and by Sec. 619, Rev. Act 1928 (Appendix, pp. 35-36).)

Petitioner submits that Congress has placed no special limitations upon the period in which a taxpayer making sales which fall within the scope of Section 44(b) of the Revenue Act of 1928, may correct a failure to use the installment basis for determining income, and that to imply a special period of limitations would work an unauthorized and illegal departure from an important and fundamental feature of that system of corrective justice which Congress has provided as a part of its revenue system. *Cheatham* v. *United States*, 92 U. S. 85; *Snyder* v. *Marks*, 109 U. S. 189, 193; *Graham* v. *Dupont*, 262 U. S. 234, 255.

In addition, the interpretation of the law by the court below defeats the purpose of the statute and regulations to alleviate the hardships involved in the use of the cash or accrual methods of determining income from installment sales (*Burnet* v. *S. & L. Building Corporation*, 288 U. S. 406, 413),

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[10] *Moran* v. *Commissioner*, 67 F. (2d) 601 (C. C. A. 1st), involved an attempt to change from a position taken in earlier tax years to a new position injurious to the public revenues, and turned upon the issue of estoppel.

and is not to be so narrowed by judicial construction (*Helvering* v. *Stockholms Enskilda Bank*, 293 U. S. 83, 93-94; *Gould* v. *Gould*, 245 U. S. 151; *United States* v. *Merriam*, 263 U. S. 179).

E. Petitioner's book entries are not controlling.

Petitioner's books erroneously reflected the installment sales as if they were cash sales (R. 108). They did not purport to reflect fair market values of the installment obligations (R. 108, 119), and hence were not kept upon the basis of "deferred-payment sales not on the installment plan" as contemplated by Regulations 74, Articles 353-354.

The Circuit Court of Appeals seems to have concluded (R. 205-206) that, because the 1928 tax return showed income from the real estate venture in accordance with petitioner's book entries, the return was necessarily a proper and binding one. Book entries are not controlling in Federal tax matters as this Court has often recognized. *Doyle* v. *Mitchell Brothers Company*, 247 U. S. 179, 187; *United States* v. *Anderson*, 269 U. S. 422, 442-443; *American National Co.* v. *United States*, 274 U. S. 99, 105; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449.

In *Commissioner* v. *Union Pacific Railroad Company*, 86 F. (2d) 637 (C. C. A. 2nd), the Circuit Court of Appeals disposed of a contention that a taxpayer's method of recording certain deferred payment sales upon its books was controlling as to how income therefrom should be computed, as follows (at page 639):

> "The petitioner contends that there was no evidence that these items were accrued on the respondent's books. But that fact is immaterial; actual bookkeeping entries do not control in the determination of the question of whether an item is income or deductible on an accrual basis, but the facts do."

It has not been suggested that petitioner's books do not permit a determination of income upon the installment basis, and the delinquent returns of the Trustee (R. 145, 149), which presumably were made from those books[11] (R. 119) and which employed the installment basis (R. 148, 153), demonstrate that the books are entirely adequate in that respect. The total profits chargeable to petitioner from operations of the subdivision to December 31, 1928, as reflected by the two delinquent returns of the trust, were $44,048.10 (R. 148, 153) and were subject to some reductions for interest, taxes and expenses (R. 150). Petitioner's determination of $137,007.17, reflected in its tax return for 1928, was grossly excessive under any view of the case.

F. No grounds for estoppel exist and no administrative burden is involved in petitioner's use of the installment basis.

The stipulation (R. 118) that no revenues will be lost to the United States by reason of the statute of limitations, if petitioner is permitted to use the installment basis, clearly disposes of any reasonable basis upon which a defense of estoppel could be founded, and that defense (although apparently raised by the Commissioner (R. 51, 52)) has not in fact been asserted by the respondent. *Helvering* v. *Salvage*, 297 U. S. 106, 109.

The suggestion made by respondent (Brief in Opposition, p. 9), and by the District Court below (R. 29), that the failure to ascertain the market values of the obligations of purchasers of the subdivision lots was merely a procedural error which might have been corrected within the scope of the "deferred-payment sales not on the install-

[11] The testimony fails to state that the returns are from petitioner's books (R. 121); however, the data corresponds, except for minor variations, with data (Petitioner's Exhibit No. 10, R. 144) which were made from the books and records of Trust No. P. T. 46 (R. 120), which records were the sources for petitioner's book entries (R. 112).

ment basis'"[12] alleged to have been elected in the return, ignores the realities of the situation and begs the basic issue. That issue is whether petitioner, by filing its original return, adopted an adequate method of reflecting income from the sales of subdivision lots and so far reflected income from the installment sales in accordance with the law and the regulations as to permit the Commissioner to refuse, in the interest of an orderly administration of the tax law, to permit the use under a refund claim of the installment sales basis originally available to petitioner.

It is suggested for the respondent[13] that the proper remedy (alleged by respondent now to be barred by limitation) was for petitioner to ask the Commissioner, by a timely claim for refund, to undertake the task of determining the fair market values on the dates of sales of the 257 contracts to purchase, which petitioner held at the end of 1928. Respondent (who is not the Commissioner but the Collector) apparently has failed to consider the magnitude and complexity of the task involved in the foregoing suggestion for, under the facts, such a course plainly would have burdened the Commissioner far more than the installment basis which petitioner seeks to have employed.

The purchaser obligations, in respect of which "fair market values" would have to be determined, were not reflected by promissory notes but were merely the contractual agreements of the purchasers to pay balances due upon purchase prices of lots. Title to these lots remained in the seller who reserved an option to permit cancellation of the obligations, in the event of defaults, upon forfeiture of pay-

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[12] Art. 354, Regs. 74; Appendix, p. 38. The statement in a stipulation (R. 43) that in petitioner's return the "sales were treated as deferred payment sales not on the installment plan and the obligations of the purchaser were treated as having a fair market value equivalent to their fair value", is primarily a legal conclusion, and is contrary to clear and unchallenged testimony of the officer who made the return (R. 108, 111-113) and other testimony (R. 119).

[13] Brief in Opposition, pp. 8-9.

ments previously made (R. 94, 96-98). In many instances contracts of this type have been held to have no market values, or values far less than their face amounts, and controversies as to such values have been numerous. Compare G. C. M. 3350, VII-1 Cumulative Bulletin, p. 62; *Cambria Development Company* v. *Commissioner*, 34 B. T. A. 1155, 1158; *Trust No. 5522, etc., Security-First National Bank, Trustee* v. *Commissioner*, 27 B. T. A. 1250, reversed as to another issue, 83 F. (2d) 801 (C. C. A. 9th); *Biscayne Bay Islands Company* v. *Commissioner*, 23 B. T. A. 731, 735; *Rapid Transit Land Sales Company* v. *Commissioner*, 20 B. T. A. 608; *Ravlin Corporation* v. *Commissioner*, 19 B. T. A. 1112; *Woodmar Realty Co.* v. *Commissioner*, 17 B. T. A. 88, 89; *Calvin T. Graves* v. *Commissioner*, 17 B. T. A. 1318, 1324.

The primary object of the Treasury regulations and of the statutory provisions allowing the use of the installment sales basis for determining income, in cases such as this, from sales with low initial payments, was to "eliminate necessity for appraisals of the obligations of purchaser" (Sen. Rep. No. 52, 69th Cong., 1st Sess., p. 19), and the remedy suggested for this petitioner is in direct conflict with the attainment of that objective.

G. The regulations applicable to closed sales offer no relief to petitioner.

Petitioner's 1928 return (R. 42) and its claim for refund (R. 17, 48, 124) show consistent losses from its other activities and, we submit, preclude any inference that the error made in the 1928 return concerning the subdivision venture could be compensated for in later years by deductions of "losses" resulting from cancellations of the defaulted contracts as contemplated by Regulations 74, Article 354.

In any event, the regulations with regard to closed sales apply to cases where the purchaser obligations have actual and determinable market values, by which income realized in the initial year of each contract can be measured. Where,

as here, there has been no attempt at determination of market values of the obligations and the income was computed on a wholly erroneous view, using a figure grossly in excess of the value of the obligations and so overstating the income in the initial year of the venture, the provisions of Article 354 are entirely inapplicable and would not be apt even if the taxpayer's situation were such that losses sustained in a later year would help it.

While taxing statutes sometimes produce illogical and even unreasonable results, only express language justifies so construing them. *Fleischmann Construction Company* v. *United States*, 270 U. S. 349, 360; *Crooks* v. *Harrelson*, 282 U. S. 55, 60. So in this case, it is not sensible that a taxpayer whose actual situation was as shown by this record should be held to have incurred a 1928 tax liability of as much of $9,669.89. On the basis of realities, its venture was visibly falling, already. Furthermore, it would be in direct conflict with the general policy of the statute, which seeks only to tax income actually received or accrued, to say that, merely because its return was erroneous, petitioner lost the right to have its taxes correctly determined.

II.

Petitioner Was Required to Return Only Its Distributable Share of the Income from Trust No. P. T. 46.[14]

Petitioner, by its amended claim for refund (R. 50-52),[15] advanced the contention that the subdivision trust was a

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[14] Although this proposition was not specifically urged in the petition for certiorari, or in the brief of petitioner, it involves an important error of petitioner, which was urged below (R. 10, 121-123, 174-176, 184-185), and was discussed by respondent in his brief in opposition (p. 10) and is, petitioner believes, properly before this Court.

[15] Compare *United States* v. *Memphis Cotton Oil Co.*, 288 U. S. 62, 71; and *United States* v. *Factors & Finance Co.*, 288 U. S. 89, 94, 96.

separate entity whose income from the real estate venture was not to be charged to petitioner, in the following terms:

> "Claimant now wishes to amend the claim by showing that the subdivision trust is a separate entity, an association taxable as a corporation, that it did not file a consolidated return with claimant in 1928, and that its 1928 income can not be included in claimant's income or return. Accordingly, the income of the subdivision trust must be excluded from claimant's 1928 income, and the tax paid thereon by claimant, refunded. This situation prevents the doctrine of estoppel from applying to this case."

Both courts below in the instant case limited their decisions to the proposition that the trust was a fixed trust in the nature of a mortgage, and being a security device, was not an association taxable as a corporation (R. 29, 199, 206). The Circuit Court of Appeals found that a decision on that point adverse to petitioner was required by the decision of this Court in the case of *A. A. Lewis & Company* v. *Commissioner*, 301 U. S. 385.

Both courts failed to decide whether or not, if the trust was not an association taxable as a corporation (Rev. Act 1928, c. 852, 45 Stat. 791, Sec. 701(a)(2)), it nevertheless was another type of taxable entity—a strict trust—of the kind required by the Revenue Act of 1928 to make tax returns reflecting its operations. Under that statute a trustee of property held in trust is required to make returns showing all income derived by it from dealings in trust property (Sec. 143; Appendix, p. 39) and to pay taxes thereon, except where (as in the case of this trust) the net income from such operations is distributable to beneficiaries (Sec. 161(a)(2) and (a)(4); Appendix, p. 39). In cases where the income is distributable to beneficiaries, the trust is required to make tax returns showing the income distributable to each beneficiary and such beneficiary is required to report such amounts in his tax return (Rev. Act 1928, Sec. 162(b); Treas. Regs. 74, Arts. 861 and 862-(2); Appendix, pp. 39, 40, 41).

On January 3, 1935 (which was after suit was brought in this case), the Successor Trustee of Trust No. P. T. 46 filed with the Commissioner delinquent fiduciary returns (R. 121-123). These returns computed gains from sales of subdivision lots upon the installment plan and reflected income distributable to petitioner in the sum of $4,821.43 for the fractional year 1927 (R. 145, 146), and $15,073.46 for the year 1928 (R. 149, 151).

Petitioner, on appeal to the Circuit Court of Appeals, assigned, among other errors, failure of the District Court to sustain the contention made in the District Court (R. 121-123, 174-176) that Trust No. P. T. 46, Pacific National Bank, Trustee, was the proper entity to report the income from the sales of the subdivision lots (R. 184, 185), and on appeal contended in its brief (pp. 12-13), in part, as follows:

> "The trust involved in this case was a separate entity, whether it is to be deemed a pure trust or an association.
>
> "As the fiduciary of the separate entity, the Trustee had the sole right and the responsibility to keep books, choose its own method of accounting, and file returns upon a method chosen by it. *Sec. 143, Revenue Act of 1928.* Compare *I. T. 2434, C. B. Dec. 1928, p. 106.* See, also, transcript pages 154, 157, inclusive.
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> * * * * * * * * * *
>
> "While the Trustee was delinquent in choosing a method of reporting and in filing its return, it eventually did so and chose the installment method.
>
> "Appellant had but one course to pursue under the law and regulations. It was required to report in its return its distributive share of the trust income as determined and reported to appellant by the Trustee, if the trust was a pure trust, and to report in its return the dividends received if the trust was an association."

If the failure of the lower courts to decide whether petitioner or the trust was the proper entity to report income from sales of the subdivision lots was based upon an unexpressed belief that the amended claim for refund did not

raise that issue, such a conclusion, petitioner submits, was wholly unwarranted.

The amended claim for refund (R. 50-52) definitely stated that the trust was a "separate entity", and that "the income of the subdivision trust must be excluded from claimant's 1928 income". Although these averments were definitely coupled with the further averment that the trust was "an association taxable as a corporation", the Commissioner was sufficiently put on notice of the basic error complained of, i. e., that the Trustee, and not the petitioner, should report the income from the subdivision sales. *Bemis Brothers Bag Company* v. *United States*, 289 U. S. 28; *United States* v. *Factors & Finance Co.*, 288 U. S. 89; *United States* v. *Garbutt Oil Co.*, No. 262 this term, and *United States* v. *Andrews*, No. 48 this term, both decided January 4, 1938.

The Commissioner could not have been misled, since he must have been fully aware that under Section 143 (a) (5) of the Revenue Act of 1928 (Appendix, p. 39) every fiduciary of a strict trust having a gross income of more than $5,000.00 was required to make returns for the trust, and that such requirement extended to trusts described in Sections 161 and 162 of the statute (Appendix, pp. 39-40). Regs. 74, Art. 862-(2), *supra* (Appendix, p. 41). Article 1314 of Regulations 74 provided in that connection as follows:

> "*Association distinguished from trust.*—Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, and the beneficiaries have no control over the trust, although their consent may be required for the filling of a vacancy among the trustees or for a modification of the terms of the trust, no association exists, and the trust and the beneficiaries thereof will be subject to tax as provided by sections 161-170 and by articles 861-891."

The operation of those regulations is illustrated in the case of *A. A. Lewis & Company* v. *Commissioner*, 301 U. S. 385, 389. The deficiency in that case was asserted against the Trust upon the issue whether the Trust was a strict trust or an association taxable as a corporation. It appears from the record in that case (No. 743, October Term, 1936, at page 7) that the Trustee filed its tax returns on Treasury Form 1041, which is the form prescribed in Article 741 (b) of Treasury Regulations 74[16] for use by a strict trust, the income of which is distributable to beneficiaries. While that fact apparently was not brought to the attention of this Court, its decision that the Trust there involved was not an association taxable as a corporation plainly did not decide or contemplate that the trust entity was to be ignored and that the two beneficiaries there involved were to be taxed as if they had carried on the subdivision venture directly.

In the instant case, Trust No. P. T. 46, Pacific National Bank, Trustee, was created in part for the security of McLeod, the seller of the land to be subdivided (R. 68-84). However, the trust could extend for a period of 20 years (R. 90) and was to be conducted for the sole benefit of petitioner or its assignees after all obligations to McLeod had been discharged (R. 84). Petitioner's primary business was that of a holding company (R. 110-111). It owned a controlling interest in the Bank which was Trustee (R. 44). Petitioner had the privilege of dividing its beneficial interest in the trust and of disposing of certificates of beneficial interest representing fractional beneficial interests in the trust. (R. 85-86). The Trustee was to have a voice in determining the manner in which the properties were to be subdivided (R. 81), and appears actually to have arranged for that work and for the selling of the lots in the first instance (R. 115-117, 141-142). Contracts of sales of the lots were to be executed by the Trustee and retained by it (R. 82). The

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[16] Appendix, p. 40.

purchase prices of the lots, including the installment payments, were to be received by the Trustee, who was to pay therefrom the expenses incurred in connection with the subdividing, improving and selling the properties (R. 82-84). The petitioner's part in the actual business of subdividing and selling the land was largely passive. Although the second contract with a selling agent (R. 54-67) under which most of the lots were sold, was made by petitioner, the entire course of business appears to have passed into the Trustee Bank, which kept its own books and gave the petitioner data on its activities (R. 112, 119). Petitioner in 1928 received no distributions from the Trustee (R. 112), and its only benefits from the trust necessarily consisted of reductions of the purchase money notes.

Petitioner contends that these circumstances bring the trust within the scope of the statute and regulations applicable to strict trusts and that its action in filing a return as if it actually carried on the subdivision operations was erroneous. The facts are quite similar to those involved in *Commissioner* v. *Highlands Evanston-Lincolnwood Subdivision, etc.*, 88 F. (2d) 355, 358 (C. C. A. 7th), certiorari denied 58 S. Ct. 11, in which the trust was held to be an association and the decision of the Board of Tax Appeals (32 B. T. A. 760) that the trust was a mere security device was reversed and remanded. The Board and the Circuit Court of Appeals seem to have recognized that if the trust was not an "association", it plainly was a strict trust and under duty to make its separate tax return as the seller.

In *Crocker* v. *Malley*, 249 U. S. 223, 235, the Collector was allowed to withhold from the refund therein authorized such amount as was due from the trust involved as a strict trust. The trust involved in the instant case is plainly the business type of strict trust referred to by this Court in *Morrissey* v. *Commissioner*, 296 U. S. 344, 359-360.

The activities and responsibilities of the Trustee in this case distinguish it, petitioner contends, from the situations described in G. C. M. 2185, VI-2 Cumulative Bulletin, p. 75,

and G. C. M. 4120, VII-2 Cumulative Bulletin, p. 108, where trust arrangements in connection with the sales of real property were permitted to be disregarded on the theory that in reality the beneficiary alone conducted the transactions. Compare the unpublished ruling of the Deputy Commissioner (R. 154-157) in the case of Trust S-6165, Title Insurance Trust Company, Trustee, in which it is stated at page 156:

> "It is the opinion of this office that inasmuch as trustees are the proper persons to file returns for trusts, and are the only persons required by law to do so, and as it further appears from the trust instrument in this case that the trustee was the only agency authorized to bind the trust, the return filed on March 15, 1928 by the trustee of Trust S-6165, Title Insurance and Trust Company, is to be recognized as the return of the taxpayer in preference to any other returns filed by other persons not properly authorized by the trustee to make returns for the said trust."

Petitioner submits, therefore, that the court below erred in failing to hold that petitioner was entitled to a refund based upon a determination of the amount of trust income from Trust No. P. T. 46, which was distributable to it, such determination to be made upon the installment plan authorized by Section 44(b) of the Revenue Act of 1928, and Treasury Regulations 74, Articles 352-353 (Appendix, pp. 34-35, 36-38). Such a method will result in petitioner's being charged with income to the extent that installment payments were applied in reduction of the purchase money notes (R. 148, 153), and will most clearly reflect the income from the venture.

CONCLUSION.

Petitioner's original return was erroneous and correction of the error was sought by a timely claim for refund. The Circuit Court of Appeals erred in finding that petitioner had lost its right to have its income from the install-

ment sales determined in the manner provided by Section 44 of the Revenue Act of 1928. The decision of the Circuit Court of Appeals should be reversed and the case remanded to the District Court for a determination of petitioner's correct tax liability.

Respectfully submitted,

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February, 1938.

APPENDIX.

Point I.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in personal property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of

indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

(c) *Change from accrual to installment basis.*—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his net income on the installment basis, then in computing his income for the year of change or any subsequent year, amounts actually received during any such year on account of sales or other dispositions of property made in any prior year shall not be excluded.

(d) *Gain or loss upon disposition of installment obligations.*—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

SEC. 322. REFUNDS AND CREDITS.

(a) *Authorization.*—Where there has been an overpayment of any tax imposed by this title, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer.

(b) *Limitation on allowance.*—

(1) *Period of limitation.*—No such credit or refund shall be allowed or made after two years from the time the tax was paid, unless before the expiration of such period a claim therefor is filed by the taxpayer.

(2) *Limit on amount of credit or refund.*—The amount of the credit or refund shall not exceed the portion of the tax paid during the two years immediately preceding the filing of the claim, or if no claim was filed, then during the two years immediately preceding the allowance of the credit or refund.

* * * * * * * * * *

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 1111 (as amended by Section 619, Revenue Act of 1928, c. 852, 45 Stat. 791). Section 3220 of the Revised Statutes, as amended, is amended to read as follows:

"SEC. 3220. Except as otherwise provided by law in the case of income, war-profits, excess-profits, estate, and gift taxes the Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal-revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

Treasury Regulations 74, Revenue Act of 1928:

ART. 352. *Sale of real property involving deferred payments.*—Under section 44 deferred-payment sales of real property fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or

property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 40 per cent of the selling price.

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 40 per cent of the selling price.

Sales falling within class (1) and class (2) alike include (*a*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (*b*) sales where there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

* * * Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "selling price."

ART. 353. *Sale of real property on installment plan.*—In transactions included in class (1) in article 352 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

*If the vendor had retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property by agreement or process of law, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor and (2) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the

*Amended by T. D. 4360, XII-1 C. B. 116.

purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale. * * *

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

ART. 354. *Deferred-payment sale of real property not on installment plan.*—In transactions included in class (2) in article 352, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

If the vendor had retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property by agreement or process of law, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor and (2) the sum of the profits previously returned as income in connection therewith and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale. * * *

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

Point II.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 143. FIDUCIARY RETURNS.

(a) *Requirement of return.*—Every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

* * * * * * * * *

(5) Every estate or trust the gross income of which for the taxable year is $5,000 or over, regardless of the amount of the net income;

* * * * * * * * *

SEC. 161. IMPOSITION OF TAX.

(a) *Application of tax.*—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including—

* * * * * * * * *

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

* * * * * * * * *

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

* * * * * * * * *

SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * * * * * *

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust, the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. * * * .

Treasury Regulations 74, Revenue Act of 1928:

ART. 741. *Fiduciary returns.*—Every fiduciary, or at least one of joint fiduciaries, must make a return of income—

* * * * * * *

(b) For the estate or trust for which he acts if the net income of such estate or trust is $1,500 or over, or if the gross income of the estate or trust is $5,000 or over, regardless of the amount of the net income, or if any beneficiary of such estate or trust is a nonresident alien.

The return in case (*a*) shall be on Form 1040 or 1040 A. In case (*b*) a return is required on Form 1040 with respect to any taxable net income of the estate or trust computed in accordance with section 162 and a return on Form 1041 with respect to any income deducted under section 162 (b) or (c). If a portion of the income of the estate or trust is retained by the fiduciary and the remainder its distributable or distributed to beneficiaries, both Forms 1040 and 1041 will be required. (See article 862.) * * *

ART. 861. *Estates and trusts.*—In general, the income of a trust for the taxable year which is to be distributed to the beneficiaries must be returned by and will be taxed to the respective beneficiaries, but the income of a trust which is to be accumulated or held for future distribution, whether consisting of ordinary income or gain from the sale of assets included in the corpus of the trust, must be returned by and will be taxed to the trustee. * * *

See section 143 and articles 741-746 with reference to fiduciary returns, and section 24 and articles 281-284 with reference to items not deductible. (See also article 154.)

ART. 862. *Method of computation of net income and tax.* * * *

(2) The amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, shall be allowed as an additional deduction in computing the net income of the estate or trust. The amount so allowed as a deduction must be included by the beneficiaries in computing their net income, whether distributed to them or not. * * *